

HOUSE BUDGET COMMITTEE

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What Happened to the Surplus?

Comparing the Cost of the Tax Cut with the Cost of Responding to September 11

An Analysis by

The House Budget Committee Democratic Staff

This document has not been reviewed and approved by the Democratic Caucus of the Budget Committee and may not necessarily reflect the views of all members.

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Introduction

Projected surpluses over the next ten years have declined dramatically due to a combination of the Republican tax cut, the recession, and the costs of responding to the terrorist attacks of September 11. However, many believe that the costs of September 11 are as much, if not more, to blame for the decline of the surplus as either the Republican tax cut or the recession. This belief is not correct, as this analysis shows.

This analysis compares the relative size of the tax cut with the costs of September 11 and finds that the Republican tax cut is at least three times larger. While estimating the cost of September 11 is inherently uncertain, the analysis attempts to include all probable costs. If costs are more modest, and if the Republican tax cut is not repealed after 2010, the ratio of the impact on the surplus between the tax cut and the costs of September 11 is likely to be about 4.5 to 1.

While the Republican tax cut is the single largest reason for the decline of the surplus over the 2001 - 2011 period, the recession is also a factor, particularly in the next few years. Previous analyses by the House Budget Committee Democratic staff consider the impact of the recession and are posted on: http://www.house.gov/budget_democrats. This analysis instead focuses on the relative size of the cost of the Republican tax cut and the cost of responding to September 11.

Some of the future costs of responding to September 11 are already built into the Congressional Budget Office (CBO) baseline surplus estimate. It is only costs in addition to those already assumed in the baseline that will cause a further deterioration of the surplus. The *Appendix* provides a detailed discussion of this and related issues.

Cost of September 11 Legislation to Date

Congress responded to the terrorist attacks of September 11 by enacting H.R. 2888, which is a \$40 billion emergency supplemental,¹ and H.R. 2926, which is a bill to assist financially troubled airlines and compensate the families of the victims of the tragedy. Table One summarizes the cost of both pieces of legislation. For display purposes, Table One divides the \$40 billion supplemental into three broad categories: Department of Defense, Affected Communities, and Homeland Security. (For a more detailed summary of the \$40 billion supplemental, see the House Budget Committee Democrats' web site.)

Increased spending causes an increase in government interest costs, and the table includes these effects as well. As the table indicates, the total cost to the taxpayer, including interest, of September 11 legislation enacted to date is \$84 billion over the 2001 - 2011 period. The cost is

¹The \$40 billion emergency supplemental was divided into halves; the Administration had broad authority to allocate the first \$20 billion, and the second \$20 billion required subsequent legislation by Congress. Congress enacted the second \$20 billion as a separate title to H.R. 3338, the Defense Appropriations Act for Fiscal Year 2002.

Table One
The Cost of Responding to September 11:
Legislation Enacted to Date
(Dollars in Billions)

		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total, 2001 - 2011
\$40 Billion Emergency Supplemental Bill:													
Department of Defense 1/	BA	14.0	3.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	17.5
	Outlays	0.1	12.7	3.3	0.9	0.3	0.1	0.0	0.0	0.0	0.0	0.0	17.5
Affected Communities 2/	BA	3.0	8.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	11.2
	Outlays	0.0	4.4	3.2	1.9	1.2	0.4	0.1	0.0	0.0	0.0	0.0	11.1
Homeland Security & Other 3/	BA	3.0	8.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	11.3
	Outlays	0.0	4.4	3.2	1.9	1.2	0.5	0.1	0.0	0.0	0.0	0.0	11.2
Subtotal, Supplemental 4/													
	BA	20.0	20.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	40.0
	Outlays	0.1	21.4	9.7	4.7	2.7	1.0	0.1	0.0	0.0	0.0	0.0	39.8
Airline Assistance/Victim Compensation 5/													
	BA	5.0	3.0	2.4	2.4	0.8	0.0	0.0	0.0	0.0	0.0	0.0	13.6
	Outlays	2.3	4.2	3.9	2.4	0.8	0.0	0.0	0.0	0.0	0.0	0.0	13.6
Subtotal, Enacted Legislation													
	BA	25.0	23.0	2.4	2.4	0.8	0.0	0.0	0.0	0.0	0.0	0.0	53.6
	Outlays	2.4	25.6	13.6	7.1	3.5	1.0	0.1	0.0	0.0	0.0	0.0	53.4
Interest Costs 6/													
	BA	0.0	0.7	1.8	2.5	3.0	3.3	3.5	3.7	3.9	4.1	4.3	30.8
	Outlays	0.0	0.7	1.8	2.5	3.0	3.3	3.5	3.7	3.9	4.1	4.3	30.8
Total Cost of Enacted Legislation													
	BA	25.0	23.7	4.2	4.9	3.8	3.3	3.5	3.7	3.9	4.1	4.3	84.4
	Outlays	2.4	26.3	15.4	9.6	6.4	4.3	3.6	3.7	3.9	4.1	4.3	84.3

Items may not add to totals due to rounding.

Notes and Explanations:

1/ CBO estimate of DoD outlays. Includes Pentagon repairs.

2/ HBC Democratic staff estimate based on data from CBO and House Appropriations Committee. Excludes Pentagon repairs.

3/ HBC Democratic staff estimate based on data from CBO and House Appropriations Committee.

4/ Total outlays of supplemental is equal to CBO estimate.

5/ CBO estimate. Represents direct (mandatory) spending.

6/ Calculated using CBO August 2001 interest rates.

measured as outlays because outlays measure actual government spending and are used to calculate the surplus or deficit (see *Appendix* for further discussion).

Cost of Future Legislation in Response to September 11

Table Two estimates the cost of future legislation responding to September 11. The analysis considers both further funding that may be provided for the current fiscal year (2002), and the ongoing cost of fighting terrorism abroad and improving homeland security for 2003 and beyond. Estimating future costs is inherently speculative, so the rationale for each element of the estimate is described below.

2002 Supplemental: For a number of reasons, it is widely assumed that the Administration will submit a 2002 supplemental (in addition to the \$40 billion supplemental already enacted). First, the Department of Defense (DoD) did not receive approximately \$3.8 billion that the Administration requested as part of the second \$20 billion of the \$40 billion supplemental. Second, defense officials indicate that even the requested amount would be exhausted approximately six months into fiscal year 2002. Third, Appropriations Committee members of both parties have stated that agencies besides DoD will require additional funding for 2002 that was not part of the \$40 billion supplemental. And fourth, the New York delegation and others have made it clear that the affected communities will continue seeking a total of at least \$20 billion of federal assistance for rebuilding and other related needs, the amount the President pledged to provide in the aftermath of September 11. To date, New York and the other affected communities have received only \$11.2 billion.

The analysis assumes a \$20 billion 2002 emergency supplemental bill. This amount is chosen for several reasons. First, the analysis assumes that New York and the affected communities will receive the remaining \$8.8 billion needed to fulfill the President's \$20 billion pledge. Second, several press reports indicate that the DoD supplemental request could be up to \$10 billion. If these reports turn out to be true, that would leave a total of \$1.2 billion for non-DoD homeland security, which is a modest amount. To the extent that DoD receives less than \$10 billion, the analysis assumes that homeland security could be increased further. Finally, even if the President's request is lower than \$20 billion, Congress has the option of adding to the request in the appropriations process. In short, while the \$20 billion amount is speculative, there are needs both apparent and reported that can justify it.

Costs in 2003 and Beyond: It is widely assumed that new defense and homeland security missions will require resources on an ongoing basis beyond 2002. These costs are categorized in Table Two as:

- (1) Increases for homeland security, both in DoD and in other agencies, above and beyond what the nation planned to spend prior to September 11; and
- (2) Future DoD operations against terrorists abroad.

Table Two
The Cost of Responding to September 11:
Likely Future Legislation
(Dollars in Billions)

		<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	Total, <u>2001 - 2011</u>
Likely 2002 Supplemental Appropriations	BA	<i>n.a.</i>	20.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	20.0
	Outlays	<i>n.a.</i>	10.0	5.0	3.0	1.0	0.6	0.3	0.1	0.0	0.0	0.0	20.0
Likely Appropriations Increases for 2003 and Beyond:													
Homeland Security	BA	<i>n.a.</i>	<i>n.a.</i>	24.5	25.1	25.7	26.4	27.0	27.7	28.5	29.2	29.9	244.0
	Outlays	<i>n.a.</i>	<i>n.a.</i>	16.0	21.3	23.6	25.0	26.0	27.3	28.0	28.7	29.5	225.5
DoD Operations Abroad	BA	<i>n.a.</i>	<i>n.a.</i>	10.0	10.3	10.5	10.8	11.1	11.4	11.7	12.0	12.3	100.0
	Outlays	<i>n.a.</i>	<i>n.a.</i>	6.5	8.9	9.8	10.4	10.8	11.1	11.4	11.8	12.1	92.7
Subtotal, 2003 and Beyond	BA	<i>n.a.</i>	<i>n.a.</i>	34.5	35.4	36.3	37.2	38.1	39.1	40.1	41.2	42.2	344.1
	Outlays	<i>n.a.</i>	<i>n.a.</i>	22.5	30.2	33.5	35.4	36.8	38.4	39.4	40.5	41.5	318.1
Subtotal, Likely Future Legislation	BA	<i>n.a.</i>	20.0	34.5	35.4	36.3	37.2	38.1	39.1	40.1	41.2	42.2	364.1
	Outlays	<i>n.a.</i>	10.0	27.5	33.2	34.5	36.0	37.1	38.5	39.4	40.5	41.5	338.1
Interest	BA	<i>n.a.</i>	0.1	1.1	2.9	4.9	7.1	9.5	12.1	14.9	17.9	21.1	91.7
	Outlays	<i>n.a.</i>	0.1	1.1	2.9	4.9	7.1	9.5	12.1	14.9	17.9	21.1	91.7
Total, Likely Future Legislation	BA	<i>n.a.</i>	<i>20.1</i>	<i>35.6</i>	<i>38.2</i>	<i>41.2</i>	<i>44.3</i>	<i>47.7</i>	<i>51.2</i>	<i>55.1</i>	<i>59.1</i>	<i>63.4</i>	<i>455.8</i>
	Outlays	<i>n.a.</i>	<i>10.1</i>	<i>28.6</i>	<i>36.0</i>	<i>39.4</i>	<i>43.1</i>	<i>46.6</i>	<i>50.6</i>	<i>54.3</i>	<i>58.4</i>	<i>62.7</i>	<i>429.9</i>
Grand Total, Cost of 9-11*	BA	25.0	43.8	39.8	43.2	45.0	47.6	51.2	54.9	59.0	63.2	67.7	540.3
	Outlays	2.4	36.5	44.0	45.6	45.8	47.5	50.2	54.3	58.2	62.5	67.0	514.2

*Including Cost of Enacted Legislation from Table One.

Items may not add to totals due to rounding.

Addendum:		<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Pre-September 11 Homeland Security	BA	12.8	13.2	13.5	13.9	14.2	14.6	15.0	15.4	15.8	16.2
Post-September 11 Homeland Security	BA	19.5	37.7	38.7	39.6	40.6	41.7	42.7	43.8	45.0	46.1

The analysis assumes that the pre-September 11 homeland security levels² for DoD and other agencies are the 2002 levels requested by the Administration last April, adjusted for inflation in 2003 and thereafter. The post-September 11 level is the \$37.7 billion that the White House announced on January 24 will be the 2003 budget request, adjusted for inflation thereafter. Table Two represents the difference between the pre- and post-September 11 levels, which is \$24.5 billion in budget authority for 2003, growing with inflation thereafter (see Addendum in Table Two).

The cost of future DoD operations against terrorists abroad is assumed to be \$10 billion in budget authority for 2003, adjusted for inflation thereafter. The 2003 level equals the reported “reserve” for operations the President is expected to request when he submits the 2003 budget.³

As the table indicates, the budget authority level for all of these activities (the \$24.5 billion increase in homeland security funding and the \$10 billion for DoD anti-terrorism operations) is \$34.5 billion for 2003, growing with inflation thereafter. The outlays that flow from these increases in budget authority represent the future costs of September 11.

This estimate is significantly higher than the bipartisan, bicameral estimate made in October, 2001 by the chairmen and ranking members of the House and Senate Budget Committees. That October estimate was \$20 billion of budget authority per year adjusted for inflation after 2002, which would be \$20.5 billion for 2003. This analysis deviates from the joint assessment due to the much higher levels of funding that the White House has already announced.

Table Two also calculates the interest associated with the cost of this future legislation. As the table indicates, the total estimate of the cost of future September 11 legislation is \$430 billion over the 2001 - 2011 period. If operations against terrorists abroad cease after 2005, then this estimate drops to \$327 billion.

Future DoD Increases and September 11

Determining how much of any increase for DoD is tied to September 11, and how much is simply an increase that would have been proposed by the Administration in any event, will likely be debated this year. As discussed in the previous section, this analysis assumes that future DoD September 11 funding falls under two categories:

- (1) future operations against terrorists abroad; and

²The definition of homeland security funding is not widely agreed upon. For example, OMB estimates that total 2002 appropriations (including the emergency supplemental) for homeland security is \$19.5 billion, while CBO estimates it to be \$22.2 billion. If the CBO estimate was used, the nominal increase from 2002 to 2003 would be \$15.5 billion rather than \$18.2 billion. This analysis is based on the OMB estimates to ensure that the increased costs of homeland security are not underestimated.

³It is unlikely that operations will actually continue each year for the next ten years at this level. However, the analysis assumes this level to ensure that the costs of September 11 are not underestimated.

(2) any increases for DoD homeland security above the pre-September 11 levels.

The analysis thus assumes that defense spending that does not fit into either of these categories is not directly linked to September 11.⁴ One might argue that the terrorist attacks of September 11 created a political climate conducive to large defense increases, and thus all defense increases above the Administration's 2002 levels should be considered as part of the costs of September 11. However, not only is this an overly broad definition, but it also ignores the oft-repeated pledges for large increases for defense that various Bush Administration officials made prior to September 11 (see insert for examples).

The Tax Cut vs. September 11

Understanding why the surplus has dwindled so precipitously will enable the nation to better chart a fiscally responsible future course. While the recession and the events of September 11 were beyond Congress's control, the Republican tax cut certainly was not. The fiscal mistakes of the last year must be understood and agreed upon if they are to be avoided in the future.

Long-term Comparison: The stated cost, including interest, of the Republican tax cut over the 2001-2011 period is \$1.7 trillion. As Table Two indicates, the total cost of enacted and likely future September 11 legislation is \$514 billion, including interest. Graph One illustrates just how much more an impact the tax cut had on the deteriorating surplus situation than September 11-- the ratio of impact is more than 3 to 1.

The Bush Administration's Record on Defense Increases Before 9-11

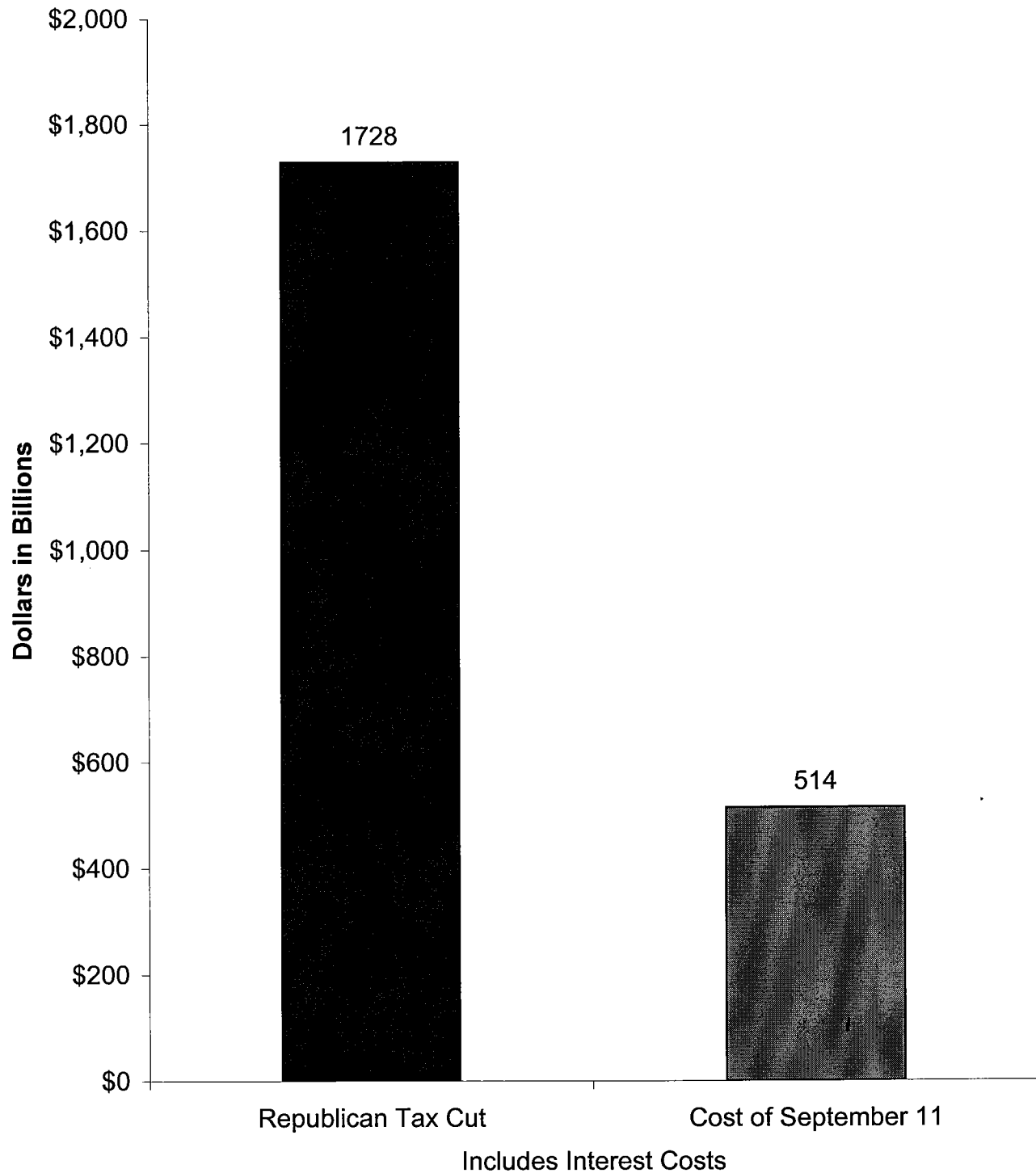
Prior to September 11, the Administration claimed that the \$18 billion defense budget amendment for 2002 was only the "first installment...of investment in restoring our national defense capabilities after years of neglect." (*Mid-Session Review*, Office of Management and Budget, August 22, 2001, p. 4).

On July 11, Deputy Secretary of Defense Paul Wolfowitz told the House Budget Committee that not spending at least 3.5 percent of the nation's gross domestic product on defense "is simply wrong." That level of funding would be \$380 billion for 2003. Recent press reports indicate that the President will request \$379 billion for DoD in his 2003 budget.

On June 28, Secretary of Defense Donald Rumsfeld testified before the House and Senate Armed Services Committees that while the 2002 increase "is a large increase by historical standards," nonetheless "it is just a good start" and "it only begins to make a dent in the leftover problems we face today."

⁴Future foreign assistance costs are not specifically addressed in this analysis primarily because it is unclear whether September 11-related foreign assistance will simply replace current foreign assistance or will be a true increase. In addition, Secretary of State Colin Powell promised to aggressively seek funding increases in this area. Finally, the extent to which the analysis overestimates costs, particularly the \$10 billion per year in DoD operations abroad, serves as a cushion if foreign assistance is underestimated.

Graph One
The Republican Tax Cut vs. 9-11



However, the \$514 billion estimate is deliberately an upper range estimate, and is much higher than the bipartisan, bicameral estimate made by the House and Senate Budget Committees last October. It assumes:

- DoD will conduct anti-terrorism operations costing \$10 billion per year plus inflation from 2003 through 2011;
- the substantial increases for homeland security that the White House has announced will be permanent increases in spending and do not include any one-time-only security improvements or temporary funding; and
- the \$20 billion pledge to New York and the other affected communities will be met in the current fiscal year.

If just the first of these assumptions is changed to assume instead that DoD anti-terrorism operations abroad will cease after 2005, then the cost of September 11 drops to \$411 billion. At this level, the ratio of impact on the surplus of the Republican tax cut compared to September 11 spending is more than 4 to 1.

On the other hand, the \$1.7 trillion estimate of the tax cut assumes that all of its provisions will indeed sunset in 2010, dramatically lowering its cost in 2011. If one assumes the Congress will not allow the tax cut to end, then the cost of the tax cut is more than \$1.8 trillion. If the costs of September 11 turn out to be \$411 billion, then the ratio between the two factors is 4.5 to 1.

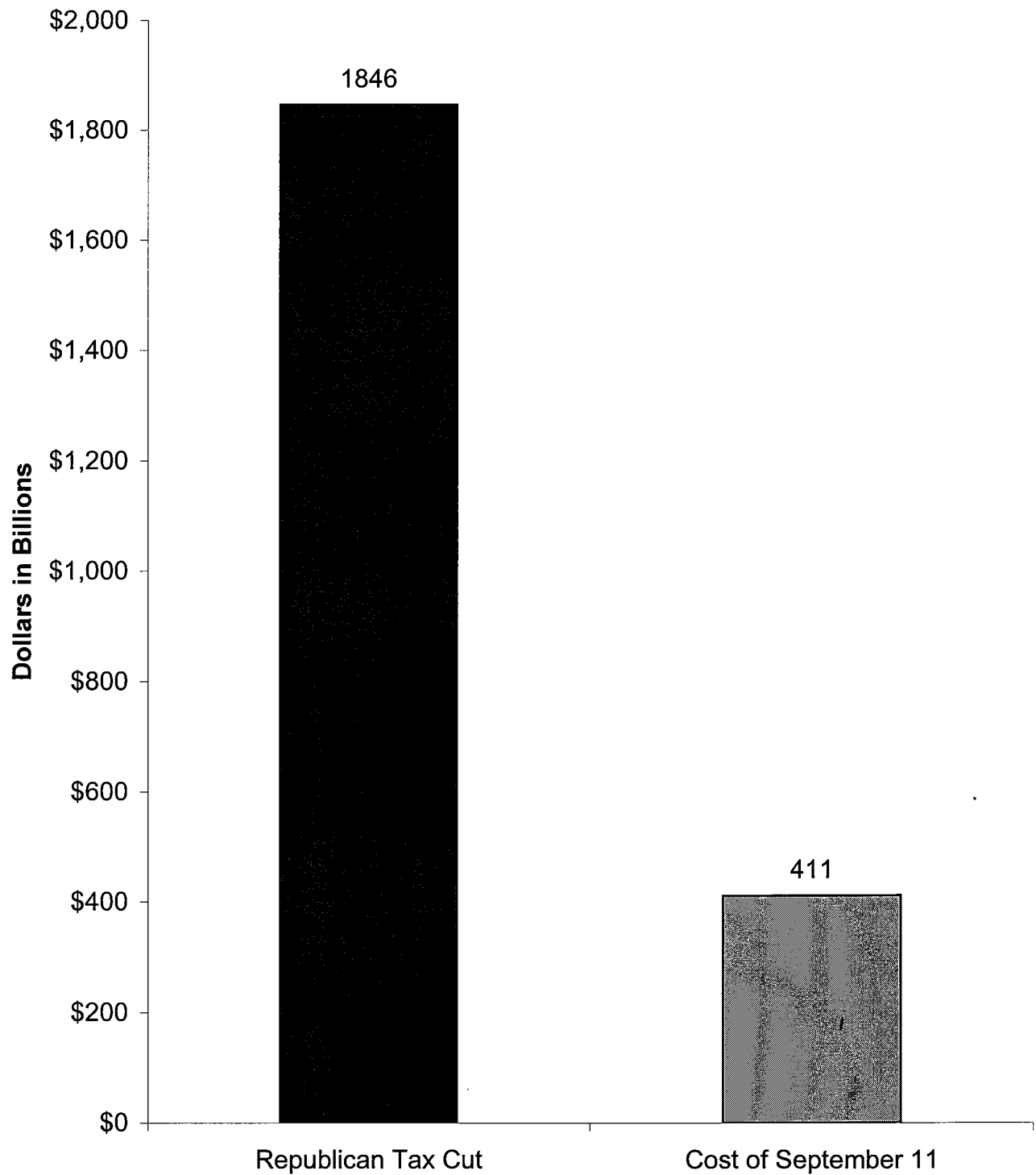
Graph Two on the next page illustrates the difference between the tax cut and September 11 under these, arguably, more likely assumptions.

Short-term Comparison: Many Republicans try to focus the debate about the dwindling surplus on just 2002 and dismiss the utility of examining the ten-year impact. One suspects that 2002 is chosen because the impact of the recession is at its greatest in this year and the stated cost of the Republican tax cut (\$41 billion) is at its smallest – only \$15 billion more than the cost of September 11 (\$26 billion prior to any additional 2002 spending).

This narrow focus on 2002 skews the fiscal picture because the stated cost of the tax cut includes a gimmick that shifts about \$33 billion of 2002 costs into 2001. More importantly, however, the focus on 2002 is too narrow because if the nation is to prepare for the impending retirement of the Baby Boom generation and its impact on Social Security and Medicare, then the ten-year fiscal picture cannot be ignored.

The oversimplification of the 2002 situation becomes apparent in fiscal year 2003, which Congress will primarily consider this session. The stated cost of the Republican tax cut in 2003, including interest, is \$98 billion, whereas the 2003 cost of September 11 spending is likely to be \$44 billion, a ratio of more than 2 to 1.

Graph Two
The Republican Tax Cut vs. 9-11



Conclusion

As devastating and tragic as the September 11 terrorist attacks were, the cost of responding to them is not likely to be much more than a half trillion dollars over the 2001 - 2011 period, and could easily be much less. However, the cost of the tax cut is \$1.7 trillion over the same period, and its cost will be more if the 2010 sunset is repealed, and Republicans have indicated that repealing the sunset is their goal.

Just one year ago, the nation had an enviable fiscal situation, but the budget has deteriorated substantially. The nation now must chart a fiscal policy that ensures that Social Security and Medicare will be viable during the retirement years of the Baby Boom generation without the luxury of large, sustained surpluses over the next ten years. The first step in developing a new fiscal strategy is understanding the fiscal mistakes of the past. The claim that September 11 is as much (or more) to blame as the Republican tax cut for the deterioration of the fiscal picture is wrong. Clearly, as most Democrats warned last year, the Republican tax cut was a mistake because it left no cushion for contingencies. The nation will be paying the price for this mistake long after the war on terrorism and the recession are over.

Appendix

The preceding analysis summarized the expected total cost of responding to September 11. This appendix analyzes three related issues that, while technical in nature, are necessary in order to understand the impact of September 11 on the budget.

First, a substantial portion of the expected future cost is already assumed by the Congressional Budget Office in its most recent projection of surpluses and deficits over the 2002 - 2012 period. Part One of this appendix discusses the extent to which CBO already assumes the likely total cost of responding to September 11 in its projections.

Second, according to several press reports about the upcoming 2003 budget request, the President plans to increase funding for the Department of Defense (DoD) by \$48 billion. In addition, the White House recently announced it will increase funding for homeland security by \$18.2 billion. However, the impact on the surplus will not be the combined total of these two increases (\$66 billion).⁵ Part Two of the appendix discusses why this nominal \$66.2 billion increase does not result in a dollar-for-dollar lessening of the surplus estimate.

Finally, Part Three of the appendix discusses issues that have been raised by CBO's practice of including "one-time-only" appropriated items in the CBO baseline. In particular, the issue of whether this practice overestimates spending, and thus underestimates surpluses in the CBO projections, is discussed.

Part One: September 11 Increases in the CBO Baseline

As this report indicates, the total cost of September 11, including interest, could be as high as \$514 billion over the 2001 - 2011 period. However, a substantial portion of these costs is already built into CBO's projection of surpluses. As part of estimating the surplus, CBO must make a projection of spending and receipts, which is called the CBO "baseline." The most recent CBO baseline covers the years 2002 - 2012. Thus, only costs that are above and beyond what the CBO baseline assumes will worsen the surplus forecast. This section explains the amount of September 11 costs already accounted for in the CBO baseline.

The CBO baseline includes all of the outlays that flow from budget authority enacted for fiscal year 2002 and prior fiscal years (see *Part Two* of this Appendix for an explanation of budget authority and outlays). For example, it includes outlays for 2002 and beyond that flow from the first \$20 billion of the \$40 billion supplemental, even though that first \$20 billion is considered to be 2001 budget authority. Of course, the outlays that flow from the second \$20 billion of the

⁵The White House has indicated that it plans to request \$37.7 billion for all homeland security activities in the 2003 budget. OMB estimates that the 2002 appropriated level is \$19.5 billion, so calculates an \$18.2 billion increase. However, the \$37.7 billion includes some DoD funding, so there is likely some overlap in the DoD and homeland security increases. This issue is addressed in section two of this Appendix.

\$40 billion supplemental are also included. In short, the outlays in Table 1 of this report that are indicated to flow from legislation enacted into law for the years 2002 - 2011 (but not 2001 since this is now outside the CBO baseline window) are already included in CBO's baseline. This is a total of \$51 billion over the 2002 - 2012 period (there are actually no costs after 2008 because the outlays that flow from these measures are estimated to end in 2008). This is shown in the first line of the table below.

The CBO baseline also includes a routine projection of spending for 2003 and beyond based upon 2002 appropriations. The second \$20 billion supplemental is thus assumed to recur in each year of the projection period, 2003 - 2012, because it is 2002 budget authority. As the second line in the table below indicates, the total amount of outlays from this recurring \$20 billion totals \$200.3 billion over the ten-year period 2003 - 2012. We assume these outlays begin in 2003 and not 2002 because the outlays that flow from the original \$20 billion as part of enacted legislation are already accounted for in the first line. While the exact nature of the spending for 2003 and beyond will differ from the mix of programs in 2002, the 2002 items serve as a proxy for future costs of responding to September 11.

In short, the baseline contains only the outlays from the first \$20 billion of the \$40 billion supplemental.⁶ However, the baseline contains the budget authority and outlays of the second \$20 billion of the \$40 billion supplemental, and assumes that this \$20 billion will continue to recur, adjusted for inflation, throughout the 2003 - 2012 period.

Interest on both the enacted legislation and the spending that CBO assumes will recur totals \$90.1 billion over the 2002 - 2012 period (third line in the table below).

**Outlays Included in the January 2002 CBO Baseline
2002 - 2012**

(Outlays in Billions of Dollars)

<u>Items</u>	<u>Amount, 2002 - 2012</u>
Enacted Legislation	51.0
2nd \$20 Billion Supplemental Assumed to Recur	200.3
Interest Costs	90.1
Total	341.4

This table shows that the CBO baseline already includes \$341.4 billion of September 11-related

⁶The outlays from the airline assistance/victim compensation bill are also included in the baseline, but are considered mandatory outlays. The \$40 billion supplemental is appropriated funding and is part of the discretionary baseline. See Part Two of the appendix for further discussion of the baseline, and the difference between discretionary and mandatory spending.

costs. It is only costs that are above and beyond this amount that will cause a further deterioration of the projected surplus.

In simple terms, any additional fiscal 2002 spending, such as another supplemental, will worsen the surplus forecast. But beginning in 2003 and beyond, only September 11-related funding that exceeds the 2002 level of \$20 billion adjusted for inflation (\$20.5 billion in 2003 and \$25.4 billion in 2012) decreases the projected surplus.

Part Two: Nominal Increases and the Surplus

The Administration has stated that it will request increases of \$48 billion for the Department of Defense, and \$18.2 billion for homeland security in its new budget.⁷ Some observers have combined these reported increases and concluded that spending will increase by \$66.2 billion over the 2002 level. This is incorrect because some portion of the homeland security funding is already counted in the DoD funding, and so the \$66.2 billion total includes some double counting.

The Administration has not yet revealed how much homeland security funding is included in its DoD increase. However, to illustrate why nominal increases in funding do not translate dollar-for-dollar into changes in the surplus, this analysis assumes that the non-DoD homeland security increase will be \$16.0 billion, for a total nominal increase of \$64 billion (\$48 billion for defense, and \$16 billion for non-defense homeland security).⁸ The numbers in this section should thus not be cited as a definitive analysis of the increase for either defense or homeland security spending.

Even though the nominal increase in funding is \$64 billion, this does not translate into a \$64 billion decrease in the projected surplus (or increase in the projected deficit). As discussed previously, one reason is that the CBO forecast already assumes some level of increased funding for defense and homeland security in its estimate of “baseline” spending. Thus, it is only increases in funding relative to the CBO baseline that determine the impact on the surplus or deficit. The second reason is that the surplus is calculated using outlays, even though most Members, the press, and the public think of programs in terms of budget authority. The \$64 billion in the example is budget authority, not outlays.

Understanding both the difference between budget authority and outlays, and how CBO calculates a baseline, is important to realizing why the \$64 billion nominal increase does not have a dollar-for-dollar impact on the surplus.

⁷As mentioned in the body of this report, much of the defense increase is not directly linked to September 11. Thus, the discussion of how an increase translates into an impact on the surplus should not be confused with the discussion of how much it will likely cost to respond to September 11.

⁸While this assumption is made for simplicity’s sake, it is consistent with indications that the non-DoD portion of what OMB considers to be homeland security activities will get the vast majority of that planned 2003 increase.

How CBO Calculates the Discretionary Baseline

DoD antiterrorism and homeland security spending are appropriated by Congress. Appropriated programs are considered “discretionary” because Congress must take legislative action each year to provide the funding; funding for these programs is not directed by permanent law. In contrast, programs that are directed by permanent law are called “mandatory,” and such programs continue year after year unless and until the underlying law is changed. Examples of mandatory spending include interest on the federal debt, and Social Security and Medicare benefits. About one-third of all federal spending is discretionary.

The purpose of the discretionary baseline is to estimate the resources it will take each year from 2003 to 2012 to provide the same amount of goods and services as was provided by 2002 appropriations. In simple terms, CBO will first “inflate” the budget authority provided by Congress for 2002.⁹ Once the necessary rate of budget authority growth is determined, CBO estimates the outlays that flow from this budget authority.

The Difference Between Budget Authority and Outlays

Budget authority is the amount of funding that an agency may commit or obligate to spend. Outlays occur when the government actually spends that funding. For example, if Congress appropriates \$5 billion for a new aircraft carrier, the Navy may sign a \$5 billion contract with a shipbuilder to construct the carrier. However, the Navy is only going to actually pay the shipbuilder as construction progresses over the seven or so years it takes to build the aircraft carrier. Thus, the \$5 billion in budget authority results in outlays spread out over seven or more years.

The surplus or deficit measures how much the government actually takes in during a given year or period and how much it spends in that same year or period. The surplus or deficit is thus calculated using outlays and not budget authority.

Nominal vs. Baseline Increases

The table on the following page summarizing DoD funding illustrates the difference between a nominal increase and an increase relative to baseline.

For purposes of estimating a 2003 surplus or deficit, the CBO baseline already assumes that DoD funding will total \$340.3 billion. The \$48 billion reported by the press refers to an increase to the 2002 appropriated level of \$331.0 billion. However, the increase in funding that is relevant

⁹The term “inflated” baseline confuses many people because they assume it simply means the 2002 level adjusted by the most commonly known inflation rate, the Consumer Price Index (CPI). However, CPI is not used at all. While there are several reasons why inflation for any given government program or agency is not equal to CPI, two fundamental reasons are (1) the cost of federal salaries is different (and usually more) than CPI, and (2) by law, CBO uses an inflation factor based on overall gross domestic product (known as a GDP deflator).

to determining how much lower the surplus will be (or higher the deficit may be) is the increase relative to baseline, in this case \$38.7 billion.

<u>2002 Appropriated</u>	<u>Baseline Level for 2003</u>	<u>Reported 2003 Request</u>	<u>Nominal Increase</u>	<u>Increase Relative to Baseline</u>
331.0	340.3	379.0	48.0	38.7

Likewise, CBO estimates homeland security funding to be \$22.2 billion in 2002. For the sake of continuing the example, this analysis assumes the non-DoD portion for 2002 to be \$12 billion and the expected 2003 request to be \$28 billion, or a nominal increase of \$16 billion. The baseline level is assumed to be \$12.4 billion. Using these assumed numbers, the increase in homeland security funding relative to baseline is \$15.6 billion, not \$16.0 billion.

Impact on the Surplus

The total increase in budget authority relative to the CBO baseline is thus closer to \$54 billion (the \$38.7 billion increase relative to baseline for defense and the \$15.6 billion increase relative to baseline for homeland security) than \$64 billion. The outlays that flow from this \$54 billion in 2003 budget authority are likely to be on the order of \$26 billion to \$30 billion, and that is the impact on the 2003 surplus.

Of course, the outlays from this \$54 billion will continue to flow beyond 2003, perhaps as long as five or six more years. In each year that these outlays occur, the baseline surplus decreases.

Additional spending relative to baseline means that there will be less federal debt retired (or in deficit years, more borrowing) than CBO assumed in its baseline estimate. The amount of outlays above baseline in each year in turn determines the amount of extra interest costs that will be incurred on top of the outlays themselves.

Reconciling Part One and Part Two of the Appendix

The first section of the Appendix concluded that a large portion of the costs of responding to September 11 are already accounted for in the CBO baseline. The analysis in this section seems to imply that the President's expected 2003 increases are very large relative to baseline. Both are true and not inconsistent with each other for two major reasons:

First, much of the defense increase discussed in this section is unrelated to September 11. Therefore, the President's large increase in defense spending will worsen the surplus situation more than the baseline assumes.

Second, focusing on only defense and homeland security (for the purpose of explaining why nominal increases in spending do not result in dollar-for-dollar changes in the surplus) is a "micro" analysis that ignores the funding in the second \$20 billion of the \$40 billion supplemental that was not for defense or homeland security, but nevertheless was

in response to September 11. These non-defense, non-homeland security items (primarily assistance to New York) serve as placeholder for the future costs of responding to September 11 even if the future funding differs in nature from the actual 2002 funding.

Putting the second point another way, from a “macro” point of view, the gross total of the second \$20 billion supplemental serves as a proxy for increases for defense and homeland security. This is particularly true if the New York assistance and other non-defense, non-homeland security items provided in the second \$20 billion supplemental are no longer necessary because they were one-time-only items, or if future funding for these items will either be less than the 2002 level or not required for much longer in the future. The next section discusses some of these issues in greater detail.

Part Three: One-Time-Only Items and the Baseline

Some observers have questioned the validity of CBO’s baseline, noting that it contains “one-time-only” items from the second \$20 billion supplemental. They believe that including “one-time-only” items overestimates future spending in the CBO baseline, and thus reduces the projected surpluses. This line of argument raises several issues.

First, the large and significant increases that the President plans for defense and homeland security will likely far exceed the amount of “one-time-only” items the baseline may contain. As discussed previously, one can view the \$20 billion as a proxy for future spending needs even if the exact mix of programs in 2002 will not be the same in the future. Indeed, the President’s expected 2003 budget request levels indicate that if anything, this \$20 billion proxy is too small, mainly because the defense request goes far beyond the requirements of responding directly to the attacks of September 11. The table below compares the spending increases proposed by the President to the entire \$20 billion supplemental rather than the baseline levels for defense and homeland security (budget authority in billions of dollars):

<u>2002 Supplemental Appropriated</u>	<u>Baseline Level for 2003</u>	<u>Reported 2003 Increase</u>	<u>Increase Relative to Baseline</u>
20.0	20.5	64.0	43.5

When viewed this way, the increase relative to baseline is not as large as the \$53 billion originally calculated in section two of the appendix, largely because this method includes the New York assistance and the section two analysis did not. Nonetheless, the increase is very significant. Presumably, much of the homeland security and defense increases will need to be sustained throughout the ten-year period of the baseline as well.

Second, the Congress provided \$40 billion in the aftermath of September 11, but only the second \$20 billion is reflected in the baseline – even though the vast bulk of the first \$20 billion will be spent in 2002 and beyond. Those who express concern that the second \$20 billion overestimates

spending seem not to appreciate that the first \$20 billion is essentially ignored because it was provided a few days before the beginning of fiscal year 2002.

Finally, Congress appropriates funding for “one-time-only” items every fiscal year. The “one-time-only” items themselves change each year, but unanticipated events continue to happen. For this reason, the baseline is usually a better forecast of future spending than a baseline that omits emergency funding. Though it may be true that the 2002 emergency supplemental did contain “one-time-only” items to a greater degree than past years, it is also evident that the President will propose more for discretionary programs this year than the baseline assumes.

In short, the CBO baseline is far more likely to underestimate than to overestimate spending needs in the next ten years. Fears that the baseline overestimates spending are likely misplaced.